

The mantra for macro-financial stability



Dr. Gurbachan Singh
Independent Economist
(Previously Visiting
Professor,
Ashoka University)

Over the last 1-2 years, we have gone through a period of some macro-financial instability in India. Some observers feel that this kind of significant instability is somewhat inevitable at times and that it is hardly possible to do anything very meaningful about this beforehand. This author differs.

This article will provide the policy mantra for ex-ante substantially improving macro-financial stability. This means that the frequency and the intensity of macro-financial instability can be reduced. For this, we need policy for not just macroeconomic stability but also policy for financial stability. The article includes new policy tools, and newer or extended versions of some policies that are familiar. It is all a very long story but a simplified version is presented here. It is based on a part of this author's forthcoming book¹ (and the references therein).

The emphasis here is on five Fs, which are

- (1) Flexible Inflation Targeting (FIT) - an extended version here,
- (2) fiscal responsibility, with minimal side-effects of policy,
- (3) floating exchange rate regime, with Fair to Impose Sudden Tax (FIST) policy,
- (4) financial regulation without financial repression, and
- (5) Financial Advice is Mandatory for Everyone (FAME) policy, though every investor is free to choose.

The first three Fs are for macroeconomic stability while the last two are for financial stability. The five Fs are not mutually exclusive and are not collectively exhaustive but

the essence is included here.

Let us consider the five policies one by one somewhat in isolation. This is followed by a perspective. The article includes a brief discussion of where we stand on macro-financial stability in India.

1 Flexible Inflation Targeting (FIT) - an extended version here

Given the paucity of policy tools with the Reserve Bank of India (RBI), it helps to prioritise, and target some inflation rate, though with some leeway. Also, the RBI can be flexible in taking care of other macroeconomic objectives including the stability of output. All this is, very briefly, the familiar FIT.

Under an extended version of FIT here, it helps if monetary policy by the RBI is accompanied by a tax or subsidy scheme by the Ministry of Finance (MoF) for stabilising the domestic price of oil and food. While the RBI takes care of core inflation, the MoF can take care of cost-push inflation to the extent possible. Overall, we move towards low and stable headline inflation.

Of course, there is a need to accept the idea of variability in tax/subsidy rates over an oil price cycle and over a food price cycle; this is unlike the idea of somewhat fixed tax or subsidy rates that we are used to at present. But there can be some rules, instead of discretion, for the variation needed. Also, we need some reserves of not just oil but gas as well, and some long-term plans for renewable energy. This is useful for energy security as well.

Finally, FIT is meaningful and realistic, provided the MoF does not have high fiscal deficits, which can affect inflation. This brings us to the next part of the policy package.

2 Fiscal responsibility with minimal side-effects of policy

In India, we have in place already the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. There is a need for an amendment to make it more effective. Also, an appropriate yardstick needs to be used to gauge the fiscal situation. This can be interest payments as a percentage of public spending, or fiscal deficits as a percentage of *public spending*. These figures stand at 20 percent and 24 percent respectively for India. These figures are very high compared to the figure of 4.2 percent, which is the fiscal deficit as a percentage of the gross domestic product (GDP), which captures *private spending and public spending* on output.

At present, the fiscal situation is, appropriately measured, not good in India (and in many other countries). So, the government bonds are actually not safe. But it does not show up as high real yields on government securities. This is because there is voluntary demand for "safe" and liquid government securities. Also, there is a captive market for government securities in India - thanks to "prudential regulations" like the statutory liquidity ratio (SLR) requirement on banks, and even the cash reserve ratio (CRR) requirement. But all this is basically financial repression. This has a downside for the bank customers and for the economy.

The bottom line here is that we need to move towards fiscal responsibility without financial repression and without violating FIT in letter or spirit. So far, we considered domestic macroeconomic stability. We turn now to exchange rate stability.

3 Floating exchange rates, with Fair to Impose Sudden Tax (FIST) policy

Floating exchange rates have the virtue that these provide an adjustment mechanism for international balance of payments but the flexibility can turn into high volatility. So, it helps that the RBI holds a good inventory of foreign

exchange reserves and meaningfully varies these to bring about stability in the exchange rates. However, this whole policy has its limitations.

Another less familiar but more useful policy can be that the legislation provides for a new tax. The MoF can invoke the tax on a temporary basis on the international capital flows, when these are large and sudden. This policy can stabilise the flows and the exchange rates. This is, what is called here, Fair to Impose Sudden Tax (FIST) policy. It is fair because the cost of stabilisation here is borne by investors who benefit from international capital flows, and the MoF gets some tax revenues. This is unlike what happens under the prevailing policy wherein the RBI bears the net cost of using foreign exchange reserves.

A variant of the FIST policy has, in fact, been used this year when the MoF imposed a 15 percent tax on imports of gold at a time when the outflows of dollars was suddenly large. This policy needs to be extended to sudden and large financial capital flows. This completes the policy for macroeconomic stability. We turn now to financial stability.

4 Financial regulation without financial repression

We need stable banks and stable non-bank financial intermediaries. So, we need appropriate regulations. We need appropriate capital adequacy norms to take care of solvency in financial institutions. Also, the RBI needs to be ready to act as the lender of last resort to deal with any systemic liquidity issues. It also helps that deposit insurance is in place.

In the aftermath of the Global Financial Crisis in 2007, new financial regulations were conceived. These include the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). While these may be useful in case of the advanced economies, it is not clear if these are needed in India, which has other regulations like SLR and CRR already. What we do need in India is some variant of the Asset Quality Review (AQR) on a somewhat regular basis.

Financial *regulation* is very much needed for the stability of financial institutions. However, this needs to be without financial *repression* (see Section 2). We turn now to the least familiar policy. This relates mainly to asset markets.

5 Financial Advice is Mandatory for Everyone (FAME) policy

As we know, there is considerable irrationality in the stock market and even asset markets more generally. The result is that the stock prices are excessively volatile. It is true that policymakers cannot make investors rational! An important difficulty at present is that many investors do not know that they do not know finance adequately and meaningfully. Their decisions affect stock prices. But policymakers can help here. The usual emphasis in this context is on expanding and improving financial literacy but this is neither necessary nor sufficient. People need credible financial advice.

Policymakers can adopt the FAME policy, which is that Financial Advice is Mandatory for Everyone. Though it is, under the proposed policy, mandatory for investors to seek financial advice, they are free to choose. It is reasonable to expect that most investors would gradually listen to the financial advice; it is in their own interest. This can reduce the role of sentiment or irrationality in the market. And, stock prices can become less volatile.

An analogy will help. In the field of medicine, people can buy medicines on the basis of a medical prescription. Similarly, there is a need for a financial prescription.

At present, the policy framework for financial advisors is not appropriate. Of course, there is a need for a big improvement in the selection, education and certification of financial advisors. And, the latter are all, under the proposed policy, required to advise on the basis of “fundamentals”, and not sentiment.

The policy suggested here is for a transition to a stage where investors get used to the idea that financial advice is indeed useful. If financial advice is mandatory, the size of the market for such advice will be huge. It is expected then that we will have greater economies of scale in the industry and the consultation fee will be affordable. The policy is useful in not just the stock market but asset markets and the financial system more generally.

This completes the five-point mantra for macro-financial stability. We turn now to an overview.

A perspective

The “new” policy tools here include (a) two tax/subsidy schemes to stabilise the domestic price of oil and food, and deal with cost-push inflation, and (b) a tax scheme to stabilise the exchange rate. Of course, the least familiar is the FAME policy here. There are also nuances here to, what are otherwise, familiar policies.

With multiple schemes, we have some “diversification” and so the burden on the fiscal deficit in any year need not be large, if at all. However, in case there is a significant effect on the fiscal deficit in any year, there can be a cut on some less important expenditure items temporarily to reduce the fiscal deficit. This makes the proposed policy here an improvement over what has come to be unconventional fiscal policy, which was used in Europe in the aftermath of the Russia-Ukraine war to deal with cost-push inflation.

A safeguard against political pressure at the MoF in framing tax or subsidy schemes for macroeconomic stability can be that we have an independent body/council which advises the MoF on the fiscal policy in so far as it deals with macroeconomic stability. The advice can be somewhat mandatory. The model here is inspired by an institution like the Finance Commission in India though this is for a different purpose.

How are we actually doing in India on maintaining macro-financial stability? Our strength is FIT though this can be improved. Also, it is good that we have low external debt. However, the fiscal deficit is, appropriately measured, very high. This needs to change. Also, we have financial repression in banks; this needs to be phased out.

Though the foreign exchange reserves have fallen substantially (particularly after considering the short positions of the RBI in the forward market) we still have large foreign exchange reserves at the time of completing this article (early June 2026). These are useful but it is better to increasingly switch to the FIST policy. Also, an important weakness in

India lies in the lack of competitiveness in international trade, and inadequate preparation in energy security, which is why the real effective exchange rate (REET) has fallen substantially over the last several quarters. So, we need to go beyond policy that is directly relevant for macro-financial stability.

On asset price stability, we do not score well but that is the case across the globe (it is a different matter that in the last several quarters the stock indices have been doing very well in several countries but not in India). There is a vulnerability in the derivatives segment, which is particularly serious in India. We could pioneer the FAME policy in India.

¹ Singh, Gurbachan, forthcoming, Macroeconomics and Asset Prices - Thinking Afresh on Basic Principles and Policy for Stability.